Extended Commentary

BLACKROCK GLOBAL FUNDS (BGF)

BGF World Mining Fund

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Market & Portfolio Performance

The BGF World Mining Fund declined -29.3% in the third quarter, underperforming its benchmark, the HSBC Global Mining Index, which returned -25.5% over the same period.

Already jittery markets fell sharply following Chairman Bernanke's announcement regarding the implementation of 'Operation Twist' and both Moody's and S&P downgraded Italian debt. Persistent concerns including the financial contagion in the eurozone, global growth and whether the Chinese economy would suffer a hard landing, all drove investor sentiment lower. The resultant risk-off trade caused an indiscriminate liquidation across most asset classes and weakness in commodities and equities prevailed.

The IMF's downgrade to world growth forecasts led commodity prices lower, with exchange traded commodities suffering as speculative long positions were reduced. The industrial metals exhibited weakness with the copper price falling -25.7% over the quarter to $3.17/lb, (source: DataStream) its lowest level in 2011. Declines were also evident across the precious metals spectrum; the silver price fell by -13.1% (DataStream), back to levels last seen in February of this year. The gold price was relatively strong by comparison remaining above $1,600/oz, an increase of 14% year to date (DataStream).

In sharp contrast to the exchange traded base metals, the bulk commodities showed relative resilience as the tight fundamentals in the market supported the prices of both thermal coal and coking coal. The iron ore price experienced a moderate pull back to $159/t (Macquarie). As yet there has been no evidence of any weakening of demand in the iron ore market; despite macro concerns in the Chinese market, steel producers do not appear to have been impacted by any significant liquidity issues.

The precarious economic situation in the developed world has, in our view, led to too narrow a focus on commodities demand over and above supply. The supply side has been significantly challenged so far this year across a number of key commodities. To give but one example: output from the world's largest copper mine, Escondida in Chile, fell 14% in the first half from the same period in 2010 due to declining ore grades and labour issues.

Despite the economic woes company cashflows are at record levels due to commodity prices averaging higher over the year. Second quarter reporting from major miners such as BHP Billiton and Rio Tinto in August showed this strength and the balance sheet of the mining sector is in good health (quite unlike 2008 when the industry was heavily indebted and largely with short-term instruments that were proved unsuitable for the longer term nature of their asset bases and cashflow profiles).

Mining company valuations, given the impact of the market weakness, now look extremely attractive. It has been no surprise to see the corporate world respond and M&A activity continue apace: during the quarter, Coal and Allied, a major coal producer in New South Wales, Australia, received a joint offer from Rio Tinto and Mitsubishi to buy out its minority investors. Both BHP Billiton and China Minmetals announced strategic acquisitions; BHP Billiton further expanded into the shale gas arena through the acquisition of Petrohawk; China Minmetals announced a bid for Anvil Mining, the copper producer and explorer operating in the Democratic Republic of Congo. This bid is indicative of the scarcity of high quality copper assets globally and the willingness of companies to take on political risk for exposure to copper assets.

As global economic issues dominated the market, investors continued their rotation out of risk assets; this was the main driver behind declines in both commodity prices and commodity equities. The most recent outlook from the IMF cast a shadow over the global economy as the organisation downgraded its world growth forecast. As a result, those commodities more closely aligned with industrial production weakened over the quarter.

Copper producers were affected by the sharp decline in the copper price as well as the negative equity market sentiment. As a result, the portfolio's exposure to this sub-sector detracted from performance over the period, with high beta names such as First Quantum bearing the brunt of the equity market liquidation. Teck Resources suffered both from the weaker copper price as well as the softening coking coal price, our overweight to this stock was also a significant detractor from relative performance.

The portfolio’s underweight to companies of a more defensive nature, such as the large cap gold names, also contributed to the Fund’s under performance.

The Fund benefited from its holdings in Coal and Allied and Anvil, which were both subject to M&A activity over the quarter. Following the election in Peru, Mr Humala a candidate with a leaning towards the left of the political sphere was elected. Once in office the reality of his tax proposals were more benign than had been originally expected. As a result, both Buenaventura and Cerro Verde recovered from their falls earlier in the year, contributing to performance over the quarter.

Transactions & Portfolio Activity

Over the quarter we maintained our allocation to cash and near-cash instruments, such as companies that have been subject to bids (eg Coal and Allied and Anvil). This provides the portfolio with a slightly more defensive stance and the flexibility to take advantage of liquidity driven market opportunities as they arise.

We increased the portfolio’s allocation to the gold sector through initiating a position in the large cap gold producer Barrick and adding to our holding in the gold ETF.

We continued to reduce our exposure to smaller cap names that need to raise capital in order to develop new/existing projects as well as those with limited cashflow.

Market Outlook

During much of 2011, the mining sector has faced the headwinds of an uncertain macro-economic environment. This has obscured the strong underlying fundamentals from which the sector is benefitting. Solid demand, particularly from emerging markets such as China and India, coupled with supply-side constraints have kept markets relatively tight. This has resulted in record earnings in the first half for many of the Fund's major holdings.

During the recent sell-off, mining company valuations look extremely attractive across a variety of metrics such as earnings and cash flow multiples and price to NAV levels. The balance sheet of the mining sector is now significantly stronger than it was in 2008; companies are better positioned to weather market volatility as well as supporting growth of dividends and share buybacks.

A near-term catalyst for the mining sector would be a a greater degree of certainty over the outlook for the US and European economies and that Chinese monetary policy is moving away from credit tightening. This should refocus the market on the strong underlying fundamentals and provide reassurance over continued strength in the Chinese economy and in turn commodity demand growth.

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